Michael J. Prell
February 1, 1995

FOMC BRIEFING

Anticipating that time would be short today, we tried to make sure that we hit all the crucial points in the two parts of the Greenbook. On the assumption that we succeeded, I'll just quickly underscore the highlights of our forecast, particularly as they relate to 1995. Peter Hooper will then comment on the external sector. And I'll wrap up with a summary of the forecasts you submitted for use in the Humphrey-Hawkins report.

First, as you know, we've changed the monetary policy assumption for our projection, to one of a stable federal funds rate. I think we made this clear, but let me emphasize that this change did not reflect an abandonment of our basic view that further tightening is needed if you wish to avoid a deterioration in the trend of inflation. Rather, we shifted our assumption partly because comments at recent meetings suggested that some of you preferred to approach the policy decision by thinking about what would occur if you left the funds rate at the prevailing level. Indeed, for some years now, it has been our practice to base our forecast on a no-change assumption except when it was fairly clear that the Committee was anticipating substantial policy moves, or when it was our judgment that such a funds rate level would produce results that were obviously unacceptable to you. Hopefully, by exploiting this flexibility, we maximize the probability that our projections will provide a useful reference point for your discussions.

One thing that made it a little easier to lower our baseline funds rate path this time was the fact that we had decided to adopt a tighter fiscal policy assumption. In a sense, the change we've made could be characterized as conservative. That is, while we've taken it for granted that the Congress will pass a balanced budget amendment, we've assumed that this will not cause a revolution in either budgetary actions or market perceptions by the end of 1996. Our thinking is that it will be a while before ratification is assured, and that--though lip-service will be paid to implementation in the coming months--the wrangling over the particulars will permit enactment of only moderate budget cuts. To be sure, all of this is highly conjectural, but we think it moves us closer than we were before to the likely fiscal reality.

On balance, these revised assumptions have caused us to raise our projection of real GDP growth to 2-1/4 percent this year and 2-1/2 percent in 1996--about a half percentage point per year faster, on average, than in the December Greenbook. The drop-off in growth that we are forecasting for this year from the 4 percent pace of 1994 obviously is substantial, and we feel kind of lonely when we look at outside forecasts--many of which have greater growth this year, with rising interest rates. And we recognize that there are only a few hints at this point that any softening in demand is in train: some shaky early estimates for retail sales late last year, and some anecdotes--sometimes supplied by industry advocates--regarding a recent weakening in demand for autos and houses.

But we've persuaded ourselves, at least, that the risks to our output forecast are reasonably balanced. The upside risks include the indications of upbeat consumer sentiment and signs that employment is still growing rapidly enough to generate healthy gains in spendable income; there also is a very strong tone to capital goods manufacturing and nonresidential construction. On the downside, although we think most of the inventory investment in the fourth quarter was intended, the rate--which BEA guessed to be somewhat higher than we did--does not seem likely to persist unless expectations of higher prices become a much greater force than they have been to date; in fact, it is not hard to imagine a sharper gearing down of the rate of accumulation than we have forecast, which could put a considerable dent in the momentum of the economy. It might also be argued that the risks attending the recent developments in the international sphere have a downside bias in the near term, insofar as the prospects for our net exports are concerned. Peter will be focusing on that issue in a few moments.

In any event, even with the rather tepid growth path we have forecast, we believe that pressures on resources will remain appreciable and will result in an upward creep in the underlying rate of inflation. Again, this projection is something of an act of faith. There has been no statistical evidence to date of a firming in the underlying trend of retail prices. To the contrary, the fourth quarter saw a drop-off in the rate of increase in the core CPI. And, yesterday's report on the Employment Cost Index showed an increase of only 3.1 percent in private industry compensation over the past year--two-tenths less than in the twelve months ended in September, and two-tenths less than we forecast.

This record understandably has encouraged those who subscribe to the view that "the world has changed" with regard to inflation. And we can't rule out the possibility that the recent good news is signaling a fundamental change in the behavior of the economy. But, realistically, given the noise in the data--and with unemployment having pierced the 6 percent level we assumed to be the NAIRU only a few months ago--it is just too early to expect that a change in the trend of inflation would be clearly identifiable. Also arguing against rejection of our basic model at this point is the anecdotal evidence in the Beige Book and elsewhere that plainly suggests a considerably more inflationary tone to labor and product markets over the past few months.

Unfortunately, though it would be nice to think that the next couple of CPI readings will settle the issue, experience--such as that in the late 1980s--shows that the emergence of pickups in inflation can be difficult to discern until the process is well advanced. Thus, we could well be in the position of having to make some difficult judgment calls for a while, utilizing all of the statistical and anecdotal information we can gather to assess the trends of wages and prices.

At this point, let me turn the floor over to Peter.

****

February 1, 1995
Peter Hooper

FOMC Briefing

In recent weeks, developments in the international sphere have been more in the center stage than usual. The peso crisis and, to a lesser extent, the earthquake in Japan not only have rocked international financial markets but also affect the outlook for U.S. economic activity. I'll briefly review these events and their implications and summarize our outlook for both the global economy and the international sector of the U.S. economy.

Turning first to Mexico, our baseline forecast had assumed Congressional approval of the $40 billion securities guarantee package. The multilateral support package announced yesterday is of course intended to play the same role. Given this degree of support, we projected that the peso would stabilize in the vicinity of 5.0 per dollar and that Mexican interest rates would recede enough to keep the economy from dropping into recession. At the same time, we expect that Mexico's macroeconomic stabilization program will reduce GDP growth to near zero this year, down from 3 percent in 1994, and will yield enough wage and price restraint to ensure the peso will have depreciated about 20 percent in real terms. Under these outcomes, Mexico's external deficit would be cut roughly in half this year and somewhat more next year, from the $28 billion deficit estimated for 1994. We expect most of this adjustment will fall on the United States, and will reduce U.S. net export growth by an amount equal to nearly 1/4 percent of GDP, with much of that effect coming in the first half of the year. Absent the multilateral support package, we would see a much weaker peso, higher Mexican interest rates, a significant recession in Mexico, and a greater decline in U.S. net exports--amounting to perhaps another 1/4 percent of GDP.

While the United States stands to feel the largest direct effects of Mexico's impending external adjustment, other countries have already felt negative repercussions from the peso crisis. Argentina and Brazil, the two countries whose monetary systems come closest to Mexico's, have suffered substantial declines in their stock markets and some increases in interest rates. As a result, we have revised our projections of real growth in these two countries down somewhat. Assuming the Mexican situation is contained, however, we do not expect these or other Latin American economies to deteriorate further or enough to affect the United States significantly.

Canada has its own external and internal deficit problems, along with a good deal of political uncertainty, and accordingly, has been vulnerable to shifts in investor confidence. In this context, it has felt some of the fallout from Mexico, with a weakening of the Canadian dollar in recent weeks that prompted the Bank of Canada to raise call money rates sharply. This monetary tightening, along with what is likely to be an austere federal budget released later this month, should take some steam out of Canada's rapid economic expansion. Some monetary firming in Canada probably would have been in order in any case, despite its continued favorable price performance. While Canada is still somewhat behind the United States on the cyclical curve as gauged by the magnitude of its potential output gap, resource utilization has tightened considerably in the industrial sector and industrial materials prices have accelerated recently.

Turning next to Japan, the earthquake is expected to have disrupted transportation and other infrastructure enough to reduce GDP growth in the first quarter by roughly 1 percentage point, although this is still at best only a rough guess. Rebuilding, which will be financed in part by supplemental budgets and in part by reduced private savings, should result in a modest net gain in GDP growth later this year and in 1996. The implications for U.S. net exports could actually be a small positive in the near term, as the destruction of Kobe's port facilities will likely reduce Japanese exports more than it does U.S. exports to Japan. The net effect on U.S. GDP should be minimal however. Some transitory price pressures may arise in Japan as a result of bottlenecks created by the earthquake, but given the substantial degree of economic slack in Japan, and with GDP growth expected to be relatively moderate, underlying inflation should remain very low for the next year or two at least.

In Europe, a strong cyclical recovery has been under way for over a year now. Growth of industrial production appears to have slowed a bit in the fourth quarter from its very strong pace earlier in 1994. Nevertheless, we expect GDP growth to remain strong this year as the composition of the expansion shifts from exports and inventories to final domestic demand. This shift should also stimulate demand for U.S. exports to Europe, which were surprisingly sluggish last year.

With growth in the major developing countries generally expected to continue at near the strong pace recorded in 1994, the world economy is undergoing virtually a global expansion. At currently anticipated growth rates, other industrial countries are roughly one to three years behind the United States in terms of potential output gaps, with Germany closest behind and Japan furthest. Unemployment is still comfortably above estimated natural rates in most countries and the risk of near-term wage acceleration is generally low. However, manufacturing capacity utilization suggests a somewhat tighter picture. Most countries have surpassed their average utilization rates of the past two decades. Last year's expansion of industrial production in Europe in particular far exceeded earlier expectations. Price pressures in industrial materials and even some final products have shown up in several countries. Absent further supply shocks, like the 1994 freeze in Brazil's coffee region, commodity price inflation should slow from last year's high, but we expect demand pressures to keep those prices rising in real terms. Overall, our expectation is that CPI inflation abroad will be slightly higher this year and next than last year, and that U.S. import prices will continue to rise a bit faster than domestic prices, at least through 1995.

Abstracting from Mexico for the moment, we expect that a robust expansion of U.S. exports over the next two years will be underpinned by continued strong growth abroad and the recent and anticipated further weakening of the dollar. In our baseline forecast we have projected that the exchange value of the dollar against the G-10 currencies would decline by several percentage points over the next few months under the assumption of an unchanged federal funds rate. Relative to our December forecast, this path of the dollar, in itself, stimulates real net exports over the next two years by an amount equal to 1/2 percent of GDP. Import growth should slow from very high rates seen last year as the economy decelerates and the effects of the lower dollar show through. Nevertheless, with U.S. output remaining near capacity, the expansion of imports should just about keep pace with that of exports, yielding only a moderate uptrend in net exports. When Mexico is added to the equation, we project total net exports will decline this year but will pick up somewhat in 1996. This outlook is consistent with the U.S. current account deficit widening to the neighborhood of $200 billion by the end of this year and remaining there during 1996--an amount well in excess of 2-1/2 percent of GDP.

The economic forecasts for 1995 that you submitted are summarized in the handout. As usual, we have not specified a federal funds rate path for your projections. We've only asked that, pending the outcome of this meeting, you assume that the Committee adopts what in your own view would be the optimal monetary policy. Given that fact, I can't say much about the causes of differences between your forecasts and the staff's. For whatever reasons, the vast majority of you have predicted both stronger real growth and higher inflation for this year than we have.

As you can see, the real GDP forecasts range from 2 to 3-1/4 percent, with a central tendency--defined as roughly the middle two-thirds--of 2 percent to 3 percent. Your inflation forecasts range from 2-3/4 to 3-3/4 percent, with most between 3 and 3-1/2 percent. The unemployment rates range from 5-1/4 percent to just over 6, but are for the most part close to 5-1/2 percent.

The law requires that the Board assess, in the Humphrey-Hawkins report, the consistency of the System's monetary policy plans with the Administration's short-run economic forecasts, as published in the Economic Report of the President. The Administration has not yet published its numbers, but judging from what we have heard, it appears that their forecasts for both growth and inflation will be within your central tendency ranges. Their unemployment rate may be appreciably higher, however, owing to an artifact of their budget preparation process, which forced them to lock in economic assumptions before the late-1994 decline in joblessness had been revealed; they may find a way of revising their numbers for the Economic Report only, but if they don't, it could raise some questions. For what it's worth, though, the output-unemployment relationship in your central tendencies looks more conventional than theirs.

February 1, 1995

Long-run Ranges
Donald L. Kohn

Mr. Chairman, in the interest of time, I will forego a discussion of the long-run scenarios in the bluebook. I would, however, like to touch on one major uncertainty in the intermediate-term outlook--that for fiscal policy.

A major shift in fiscal policy could greatly affect the conduct of monetary policy, and in ways that may not exactly follow the outlines of standard models. In our exercises, balancing the budget lowers equilibrium real interest rates over time by 1-1/2 percentage points, as compared to a current services baseline. In effect, this would reverse the effects of the jump in structural deficits that occurred in 1981, which evidently raised real interest rates in the 1980s. As the Committee is aware, however, the precise relationship of equilibrium rates to budget deficits is not easy to pin down. Other factors, such as financial innovation, real estate booms, or enhanced returns from capital investment, may have accounted for at least a portion of the higher real rates since the early 1980s.

Even if we could be sure how much equilibrium real rates would fall as a consequence of fiscal restraint, the appropriate path for monetary policy will depend on the dynamics of the responses of spenders and financial markets to the fiscal policy changes. We assumed that financial markets would catch on only gradually as deficit reduction is implemented. But bond rates could fall more sharply to new equilibrium levels once markets became convinced that future deficit reduction will in fact be implemented. If there is little anticipatory behavior in the spending of households and businesses, tighter fiscal policy can actually be stimulative for a time, as lower bond rates boost spending before actual deficit reduction measures kick in--as perhaps we saw in 1993. If the Federal Reserve were worried about inflation risks, it wouldn't want to react to falling real bond yields associated with deficit reduction by immediately lowering the federal funds rate, and in theory it might even want to run with a tighter policy than otherwise for a period.

Of course, one can imagine some forward-looking spending behavior as well. Additional saving might come, for example, from government workers anticipating layoffs or social security recipients expecting their COLAs to be trimmed. The larger point is that the effects on the economy of major deficit reduction will be difficult to predict; they will depend importantly on the nature of the cuts and their credibility, and forward-looking behavior will not necessarily be confined to financial markets--though it's more likely to be stronger there. In these circumstances, relatively simple and straightforward formulations for compensating monetary policy responses are likely to be wrong, and the Committee will need to assess the ongoing effects of any substantial deficit reduction carefully as they occur.

Of course, money growth targets were supposed to be most useful for avoiding monetary policy mistakes in just such situations of great uncertainty about aggregate spending. Unfortunately, major doubts about the characteristics of money demand have greatly reduced the utility of such targets. Nonetheless, the Committee is required to put forward ranges for money and credit growth for the current year, and this exercise still allows the Committee an opportunity to discuss broadly what types of financial conditions it expects to be associated with its ultimate objectives for the economy.

The table on page 13 of the bluebook gives the staff's projections for money and debt for 1995 and 1996 under both the greenbook baseline forecast and the alternative simulation with rising interest rates. As you can see, we expect some pickup in growth of the broad money aggregates from 1994 to 1995, despite the slowing of growth in nominal income. In large measure this reflects the effects on opportunity costs of the interest rate assumptions. Under the staff baseline, opportunity costs would narrow as deposit rates caught up with steady short-term market rates; under the alternative, opportunity costs would widen, but not as much as they did last year because a smaller rise in market rates is assumed. In addition, some special factors holding down the growth of money last year--especially the effects of declining mortgage repayments on demand deposits--will not be a factor in 1995. Helping M2 and M3, a drop in FDIC insurance premiums should boost the attractiveness of deposits relative to nondeposits as a source of funds. Still, we are projecting a bit slower M2 growth than in standard models because we are assuming that capital market mutual funds will look a little better as long-term rates stabilize, and we expect adjustment of deposit offering rates by banks and thrifts to remain more sluggish than the models have built in.

Debt should continue on its moderate growth path. Reduced federal government borrowing is likely to be offset by greater nonfederal debt issuance as business cash flow is squeezed by declining profit margins and as retirements of tax exempt bonds that had earlier been advance refunded taper off.

Against this background, the table on page 17 presents a couple of alternatives for money and debt ranges for 1995. Alternative I continues the ranges chosen on a provisional basis last July. These ranges do encompass staff projections for money and debt under either the baseline or tighter scenario. Committee members seem to be anticipating appreciably faster growth of nominal GDP than is the staff; nonetheless, I suspect the alternative I ranges would encompass money and debt growth consistent with your projections as well. If there were a question, it would be on M3. This aggregate had a higher trend rate of growth than M2 prior to the S&L debacle and bank problems of the late 1980s. Recent strength may suggest that with depository troubles having been resolved, the tendency for M3 to undershoot M2 evident in recent years is drawing to a close. Alternative IA includes what the bluebook characterized as a technical adjustment to the M3 range. That is, such an adjustment would not have any implications for the stance of monetary policy or the intentions of the Committee going forward, but rather would simply recognize the shifting relationship between M3 and the other aggregates. Another option would be to delay any adjustment until July, when more data will be available to determine whether the previous relationships are in fact reemerging.

The 1 to 5 percent range for M2 of alternative I also can be thought of as a benchmark for growth in this aggregate under conditions of reasonable price stability.

if velocity again becomes trendless. But it would not necessarily provide much guidance on the Committee's expectations in any given year. In the current year, if the Committee were concerned about the potential for inflation to accelerate, and it wanted to signal its intention to lean against any such tendency, a lower range for M2 might be chosen. The 0 to 4 percent range of alternative II is better centered on the staff's expectation of growth consistent with rising interest rates. Presumably, the Committee wishes to see some slowing of nominal income relative to the last few years. If that requires a significant further increase in interest rates, M2 could well run close to, or even below, the 1 percent pace of 1994.

February 1, 1995

Short-run policy
Donald L. Kohn

Mr. Chairman, I will be brief. The bluebook spelled out the rationales for leaving policy unchanged or tightening by 50 basis points.

Real interest rate are now close to or even slightly above averages for the last 15 years--a period of relatively high real rates--albeit well below the peaks of 1989. At these levels, which ought to be consistent over time with some restraint on spending, a case can be made for waiting for more information about whether that restraint is taking hold before tightening further. The case is strengthened by the straws in the wind that final demand may in fact be moderating, and by the possibility that the Mexican situation could worsen and spread to other countries, contributing to financial instability and restraining our net exports. Well-behaved price and cost data hold open the possibility that output will slow and pressures on resource utilization ease before much damage has been done in terms of embedding higher inflation and inflation expectations in the economy. In these circumstances, the Federal Reserve may have some breathing room to see how some of the uncertainties seem to be working themselves out before it needs to move.

The question is whether slightly restrictive levels of real interest rates are the most likely levels to accomplish the Committee's objectives. Intermediate- and longer-term real rates do embody market expectations of significant increases in short-term rates over coming quarters, and the absence of tightening eventually would tend to lower current real rates. In the staff forecast, the current level of the funds rate is not high enough to keep inflation from rising. Additional restraint--monetary or fiscal--is needed in part to offset the effects of the momentum in spending by confident households and businesses and the push later in 1995 from exports arising out of expanding foreign demand and a lower dollar over the last year. The dollar has been weak again recently, even with the favorable price data, suggesting the possibility of lingering concerns about the factors bearing on policy here and the resultant inflation outlook.

Appreciable inflation risks and the need for moving policy more clearly into restrictive territory to counter them may also be seen as a result of the economy operating beyond its potential. That situation implies that economic expansion needs to slow substantially from its recent pace to limit any pickup in inflation; it may also suggest relatively small risks of overshooting--of tightening so much that the economy is pushed substantially below potential before corrective action can be taken.

So far, there is little evidence from financial markets that tighter policy is constraining borrowing or the availability of credit. Risk spreads are very narrow, implying markets don't see problems for borrowers even with the rate increases built into yield curves. And banks continue to ease terms and conditions for loans, offsetting in part the effects of Federal Reserve tightening. Even the broader monetary aggregates have picked up in recent months, though their long-term trends remain quite damped. Growth of M2 and M3 in January was the most rapid in several years. We don't see this sort of growth being sustained, though we do expect expansion of the broad Ms to continue to exceed that of the last few years. Faster money growth, along with the strength in bank lending it has funded, may be one more indication that higher rates have not yet begun to bind significantly on borrowing and spending.